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Corporate Governance in a Risk Society

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Abstract Under conditions of growing interconnectedness of the global economy, more and more stakeholders are exposed to risks and costs resulting from business activities that are neither regulated nor compensated for by means of national governance. The changing distribution of risks poses a threat to the legitimacy of business firms that normally derive their legitimacy from operating in compliance with the legal rules of democratic nation states. However, during the process of globalization, the regulatory power of nation states has been weakened and many production processes have been shifted to states with weak regulatory frameworks where businesses operate outside the reach of the democratic nation state. As a result, business firms have to address the various legitimacy challenges of their operations directly and cannot rely upon the legitimacy of their regulatory environment. These developments challenge the dominant approach to corporate governance that regards shareholders as the only stakeholder group in need of special protection due to risks not covered by contracts and legal regulations. On the basis of these considerations, we argue for a democratization of corporate governance structures in order to compensate for the governance deficits in their regulatory environment and to cope with the changing allocation of risks and costs. By way of democratic involvement of various stakeholders, business firms may be able to mitigate the redistribution of individual risk and address the resulting legitimacy deficits even when operating under conditions of regulatory gaps and governance failure.

Keywords Corporate democracy · Corporate governance · Globalization · Legitimacy · Risk

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Introduction

With the power and latitude of firms in a globalized economy rapidly expanding, their actions affect an ever wider range of individuals, such as workers in complex global supply chains, persons affected by pollution, or other kinds of negative externalities, although the firms in many cases are not legally accountable to these individuals. Consequently, more and more stakeholders of business firms are individually exposed to risks and costs resulting from the operations of business firms in cases where the regulatory power of national governments is incapable of mitigating or socializing these risks. That is, the harmful consequences of the activities of business firms are imposed on individuals without their consent and without protection through regulatory frameworks: "the burden of risk migrates from the jurisdiction of institutions to the individualized sphere of personal decision-making" (Mythen 2005, p. 130). This individualization of risks beyond the reach of regulatory protection is a major feature of contemporary society, which has been characterized as a *risk society* by Beck (1992, 1999). Business firms are an important source of risks in risk society (Matten 2004; see also Gephard et al. 2009). Therefore, the individualization of risks is a threat to the legitimacy of a firm, i.e., its social acceptance (Palazzo and Scherer 2006; Suchman 1995). Since legitimacy is a vital condition for an organization, such cases potentially jeopardize the survival of the firm (Meyer and Rowan 1977).

The dominant approach to corporate governance advocates the primacy of shareholders (Daily et al. 2003; Judge 2009) due to the residual risk borne by them (Easterbrook and Fischel 1996; Williamson 1985; see also, critically, Stout 2002) and the efficiency allegedly accruing from the concentration of corporate governance on the generation of shareholder value (Hansmann and Kraakman 2001; Jensen 2002; Sundaram and Inkpen 2004; see also, critically, Elhauge 2005). The first aim of this paper is to show that this approach to corporate governance—as well as many alternative approaches—considers adequately neither the risks accruing from changing economic and political conditions of business firms operating in a global environment nor the resulting legitimacy problems of business firms. The second aim is to develop an alternative conception of corporate governance that can better address the individualization of risk by means of a democratization of corporate governance. We extend current research on the inclusion of stakeholders in corporate governance (see, e.g., Driver and Thompson 2002; Gomez and Korine 2005, 2008; Scherer et al. 2013) in several respects: First, we identify an increasing exposure of individual stakeholders to the risks and costs that emanate from business activities and analyze the incompatibility of this development with shareholder-centered approaches to corporate governance. Second, we elaborate on a selection criterion for stakeholders who should be represented in corporate governance. Third, we conceptualize the required democratization—by law and soft law—of corporate governance as a means for governments and transnational organizations to indirectly tackle global governance gaps.

The paper is structured as follows: In the second section, two central justifications of the shareholder-centered conception of corporate governance will be delineated, and their appropriateness vis-a-vis the shifting division of power between economic and political actors and the resulting individualization of risk will be explored. In addition, we will discuss alternative approaches to corporate governance regarding their potential to address these issues. In section three, we will argue that a shift in the scope of corporate governance is necessary to appropriately determine which stakeholders need to be included in corporate governance. In the fourth section, we suggest how democratic processes can be implemented in organizations to guarantee a fair allocation of risk and to legitimize corporate power. The approach of deliberative democracy to corporations will be discussed as a possible conceptual foundation of this endeavor. These ideas will be exemplified by referencing the empirical example of stakeholder panels. Conclusions and suggestions for further research complete this paper.

Challenges for the Shareholder-Centered Approach to Corporate Governance

In this section, we show that the shareholder-centered approach to corporate governance is justified by the residual risk borne by shareholders as well as by the socially beneficial effects allegedly accruing from the maximization of shareholder value. We suggest that both argumentations become questionable due to the changes resulting from globalization and the resulting reallocation of risk from the producers of risk and the societal level toward individuals.

Risk and Efficiency as the Foundations of Dominant Corporate Governance Theory and Practice

The shareholder-centered approach to corporate governance can be traced back to problems arising from the changing relation between ownership and control of businesses, first described by Berle and Means (1932). According to their study, an increase in the number of shareholders of corporations diminished the capacity of individual shareholders to control corporations. Professional managers gained influence and the owners lost the capacity to monitor the behavior of the managers. Assuming utility-maximizing behavior of the managers, shareowners ran the risk of managers utilizing the money supplied to the company to maximize their own utility rather than maximizing corporate value and, thus, the value of shares. Consequently, a control mechanism, which prevented the managers from shirking and misusing their fiduciary function, became necessary (Shleifer and Vishny 1997). From this perspective, corporate governance can be described as a mechanism aimed at minimizing the risk borne by shareholders, who are regarded as the owners of a firm.

In the course of the advancement of the economic theory of the firm, the conception of corporations was further developed: Initially seen as the sum of the invested capital owned by the investors, corporations were redefined as a nexus of contracts (Coase 1937; Easterbrook and Fischel 1996)—bringing into equilibrium the conflicting objectives of individuals (Jensen and Meckling 1976). While most contractual partners such as employees, debtors, and suppliers have well-defined claims on a firm and therefore bear no risk due to the enforceability of their contractual claims by legal sanctions, shareholders need to rely on the management to maximize their return by maximizing the firm value, since profit cannot be determined a priori. The relation of owners and managers of publicly traded corporations has been explained by the principal–agent theory (Jensen and Meckling 1976), highlighting the situation of asymmetric information between shareowners (principals) and managers (agents) and determining the optimal incentives necessary to prevent managers from shirking and thus motivating them to maximize firm value and simultaneously the value of shares. The (residual) risk associated with the uncertainty concerning the extent of the residual claims is regarded as the justification for the shareholders to have the right to appropriate the difference between revenue and cost, namely, the residual claims (profit) (Easterbrook and Fischel 1996; Sundaram and Inkpen 2004), and therefore an important justification for shareholder-centered approaches to corporate governance (Stout 2002).

A further justification of the shareholder-centered approach to corporate governance relates to the efficiency alleged to result from the maximization of share value. According to this view, corporate governance focussing on shareholder primacy is justified in the following way: Shareholder value is regarded as a single indicator by which shareholders and the market for securities can assess managerial performance (Jensen 2002). The assumption central to this justification of corporate governance is the view that market-based allocation is most efficient in serving the public interest if extra-economic interferences are minimized (Sundaram and Inkpen 2004). According to this position, the mechanism of corporate governance remedies the problems resulting from the separation of ownership and control in the most efficient manner by means of the market mechanism. The market for securities assesses corporate performance by means of the share price. Consequently, managers are induced to signal their performance by the maximization of the value of the shares of the corporation they work for. Further, the maximization of the value of a corporation's shares maximizes the overall productivity and value of the firm (Alchian and Demsetz 1972). Maximal productivity of a firm, in turn, is seen as the optimal contribution to social welfare, assuming that the firm is a value-generating entity and the output of efficient firms is higher than the input. Since each unit of surplus (profit) adds to social welfare, the latter is maximized by the maximization of profits (Jensen 2002). That is, by means of market coordination, private profit is aligned with the public interest as long as the maximization of shareholder value takes place within the borders of legal and moral obligations (Sundaram and Inkpen 2004). Both the residual risk borne by shareholders and the maximization of social welfare through the maximization of shareholder value can be regarded as strong moral justifications for the primacy of shareholders in corporate governance, as the debate on the control of business firms throughout the twentieth century illustrates (Berle 1932; Friedman 1970; Langtry 1994).

Globalization, Corporate Governance, and the Individualization of Risk

The dominant shareholder-centered approach to corporate governance relies on the fact that business activities take place within the borders of legal and moral obligations. However, this assumption becomes questionable in light of the diminishing regulatory capacity of nation states and the concomitant increase of power of business firms. In the following, we analyze in detail how these changes, which we regard as important facets of globalization and risk society, challenge the justifications of shareholder-oriented corporate governance theory.

Globalization can be understood as the process of expanding social relations across national borders due to declining costs of transportation, communication, and coordination (Beck 2000). In the course of this process, distances and borders are losing their significance and the scope of action of multinational corporations has expanded considerably (Chandler and Mazlish 2005; Strange 2000). Concurrently, despite the state's monopoly of the use of force, the effectiveness of national politics can be doubted in cases where corporate power and externality and public goods problems transcend national borders and become global. The increasing influence and power of multinational enterprises on the one hand and the weakening of the power of states on the other hand result in regulation gaps (Beck 2000; Chandler and Mazlish 2005; Kobrin 2001).

In the course of the shift of power between nation states and business firms, corporations play an ambiguous role (Scherer et al. 2009). On the one hand, they contribute to the efficient solution of public goods problems and engage in activities that were traditionally seen as the domain of nation states. Private actors such as businesses, NGOs, and civil society groups are engaging in the definition and enforcement of global rules and the production of public goods and thereby contribute to a new form of *global governance* that partly compensates for the diminishing steering power of national governance. Ranging from the provision of infrastructure and education (Margolis and Walsh 2003), to administration of rights (Matten and Crane 2005a), to involvement in rulemaking on the global scale, and to the generation of soft law (Abbott and Snidal 2009), corporations take on a political role besides their generic economic role (Beck 2008; Scherer et al. 2006). On the other hand, societal peace is threatened by the activities of private business firms. Examples are political lobbying benefitting corporations at the expense of the public interest (Barley 2007), the complicity with human rights violations (Kinley and Nolan 2008), and externalities such as environmental degradation (Osland 2003).

The implications of globalization and the increasing political power of business have been reflected in the business literature (Scherer et al. 2006), but have been considered in corporate governance research only to a limited extent (Scherer et al. 2013). While there is at least some work on the link between corporate governance and CSR (Bhimani and Soonawalla 2005; Jamali et al. 2008), the challenges of globalization for the dominant corporate governance model have barely been addressed (for an exception, see Boatright 2011): the growing incapacity of national governance to regulate global businesses (Beck 2008), to comprehensively protect stakeholders, or to provide global public goods on the one hand (Hertz 2001) and the corporate engagement of business firms in public tasks originally assigned to the state on the other (Matten and Crane 2005a).

The dominant shareholder-centered approach to corporate governance is justified by the residual risk borne by shareholders (Easterbrook and Fischel 1996; see also, critically, Stout 2002) as well as by the allegedly optimal effect of a shareholder concentration of corporate governance on social welfare (Hansmann and Kraakman 2001; Sundaram and Inkpen 2004; critically, see, Elhauge 2005). However, the diminishing steering capacity of states and the changing division of labor between the economic and the political system challenge these justifications. In the following, we show that the weak enforcement of contracts in many countries, the increasing significance of negative externalities such as global warming, and the involvement of business in the provision of public goods render the dominant conception of corporate governance questionable.

Weak Enforcement of Contracts

One reason for the centrality of shareholders in the dominant approach to corporate governance is the assumption of the comprehensive protection of a firm's stakeholders (except shareowners) through contracts and the legal system (Sundaram and Inkpen 2004). Accordingly, the important role of the "legal system and the law play in social organizations, especially, the organization of economic activity" and the availability of "police powers of the state (…) used to enforce performance of contracts or to enforce the collection of damages for non-performance" (Jensen and Meckling 1976, p. 311, fn. 14) are emphasized.

However, with corporations operating beyond the reach of legal enforcement mechanisms, be it in weak states or in undemocratic ones, the option of the legal protection of stakeholders becomes curtailed. In countries where state agencies are either unable or unwilling to protect the legitimate claims of stakeholders, the claimants are often exposed to the arbitrariness of powerful corporate actors. The power of stakeholders is further weakened when they have no choice other than to accept the terms determined by the corporate actors. For example, the common infringement of labor rights in the global supply chains of major electronics brands (see, e.g., China Labor Watch 2011) illustrates that even if appropriate labor rights exist, enforcement is weak in many countries. Still more unambiguous is the case of forced labor that accounts for up to 21 million workers of the global workforce (International Labour Organization 2012; see also Crane 2013). These examples illustrate that, even if there is some progress in the field of business and human rights law (see, e.g., Clapham 2006; McBarnet 2007), the assumption of the enforceability of contracts through the legal systems does not apply to the lifeworld of many workers in developing countries. More generally, they illustrate that many stakeholders lack any protection through functioning legal systems and therefore are directly exposed to risk resulting from the activities of business firms. Even if most multinational corporations are based in countries where the enforcement of contracts is strong, in the wake of globalization, these firms potentially have some ties with countries where this assumption does not hold. Hence, the problem of weak enforcement of contracts between business firms and their stakeholders is of global significance.

Negative Externalities

A further aspect of the limited capacity of many states to enforce laws relates to externalities such as environmental pollution (Beck 1992). Within the constellation of national economies, negative externalities could to some extent be limited or compensated for by public policy and by means of law. However, this option is often unavailable where no or only weak enforcement mechanisms exist (see above). Banning or preventing negative externalities by means of taxation (Pigou 1932) and proposals for the internalization of externalities by the allocation of property rights (Coase 1960) are only partially viable, since contractual obligations between stakeholders and firms cannot always be enforced. Due to the transnationality of many problems of externalities caused by corporations, as in the case of climate change and toxic emissions, and due to undeveloped cross-border regulation (Bradley et al. 1999), specific groups of stakeholders, or even all of humanity, are increasingly exposed to risks resulting from externalities generated by corporations, without the immediate chance of legal protection or compensation (Rockström et al. 2009).

Public Goods

Strongly interrelated with the described developments is the expanding power of business in general and of multinational enterprises in particular. Firms provide public goods such as education and infrastructure; they engage in the administration of rights (Matten and Crane 2005a); they provide public security services (Elms and Phillips 2009); and they participate in global governance through the formulation of international standards (Scherer et al. 2006), e.g., in areas such as labor rights and environmental protection (Haufler 2001). These examples demonstrating the engagement of corporations in the provision of public goods indicate that corporations exert significant power (Coglianese 2009), which in many cases equals or even exceeds the power of state actors (Beck 2008). While in democratic constitutional states power exercised by the state can be controlled by democratic processes, on the global level, corporate power is often uncontrolled. In such situations, individuals become exposed to corporate power without sufficient democratic authorization and control of corporate activities, and run the risk of unjust treatment.

The Individualization of Risk

In states subject to democratic rule of law, public authorities rely on their monopoly in the legitimate use of force. All stakeholders of a firm—except for the shareholders—either are assumed to be parties in explicit contracts with fixed payments that are enforceable by means of legal sanctions or are assumed to be protected by law and regulations (Easterbrook and Fischel 1996; Sundaram and Inkpen 2004). The state authorities secure compliance with regulations and contractual arrangements and allocate the costs of negative externalities either to their producers or to the society as a whole. As the sole providers of public goods, public authorities are controlled democratically and thereby misuse of power is largely prevented. Furthermore, due to its democratic entitlement and control, this exercise of power by state authorities is regarded as legitimate. The democratic state system acts as a mechanism for both minimizing and mitigating risk by limiting and socializing potential costs for the single citizen and for generating legitimacy for the use of power. Under conditions of globalization, due to insufficient state regulation and weak enforcement, many risks resulting from corporate action can no longer be mitigated by national governance and therefore are becoming more of a threat to individuals who are increasingly directly exposed to the harmful consequences of corporate activity. That is, besides shareholders, other stakeholders need to be regarded as bearing considerable risks that result from a business firm's activities from which they are not protected by law (see, e.g., Blair 2003; Boatright 2011). In other words, the risk becomes individualized (Beck 1992). The individualization of risk resulting from business activities can be regarded as a notable facet of a broader societal dynamic characterized by an increasing significance of man-made risks that can only insufficiently be tackled by regulatory frameworks. To capture these developments, Beck coined the term risk society (Beck 1992).

The reallocation of risk from the risk producers and the societal level to the individual undermines the assumption of shareholders as the sole group of stakeholders, which is exposed to risks without protection through the law. Further, the contribution of shareholder-centered corporate governance to social welfare needs to be reconsidered. Jensen (2002, p. 246) explicitly relies on "… the government in its rule-setting function…" to create the conditions necessary to resolve externality problems and admits that maximization of shareholder value does not maximize social welfare when externalities exist. The incapacity of many governments to enforce contracts between stakeholders and firms, to limit or socialize negative externalities, as well as the increasing power of business firms to unilaterally decide on matters of the public good can be regarded as evidence for the incongruence between firm-level efficiency and social welfare (see also McSweeny 2008). By challenging two important justifications of shareholder-centered corporate governance, we expand the major current moral criticism of shareholder-centered corporate governance that relates to the concentration of control in the hands of shareholders (Boatright 2004).

Legitimacy Problems of Corporate Governance

In this section, we argue that the changed allocation of risk and the weakening link between firm-level efficiency and social welfare pose a severe threat to the legitimacy of firms and identify these developments as a challenge for the shareholder-centered approach to corporate governance. Legitimacy, as defined by Suchman (1995, p. 574), "is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions." Organizational legitimacy can be based on three sources (Suchman 1995): (1) the perceptions of beneficial outcomes from the organization and its behavior (pragmatic legitimacy); (2) the organization's compliance with unconscious, taken-for-granted societal expectations (cognitive legitimacy); or (3) a moral judgment that is based on an argumentative process (moral legitimacy) in which it is judged discursively whether an activity is "the right thing to do."

Under conditions of a functioning regulatory framework, the legitimization of business firms in the market sphere is regarded to be "automatic" (Peter 2004, p. 1) due to their contribution to social welfare (pragmatic legitimacy) and their compliance of business with official rules (cognitive legitimacy). However, as soon as the risks produced by a business firm are no longer limited or mitigated by regulatory frameworks, individuals exposed to these risks might suffer a loss in individual welfare. Further, such cases are often uncovered by NGOs, civil society groups, or activists (Spar and La Mure 2003; den Hond and de Bakker 2007). Subsequently, information about corporate wrongdoing and critique can spread through media and the new communication technology instantaneously, and corporate legitimacy can be questioned globally, since a reduction of individual welfare of specific stakeholders of the firm might be regarded as a threat to social welfare by a concerned global public. Both developments can lead to the questioning of the legitimacy of this firm. That is, pragmatic legitimacy and cognitive legitimacy are becoming less reliable sources of corporate legitimacy. For this reason, moral legitimacy is becoming more relevant (Palazzo and Scherer 2006).

Several authors emphasize the importance of corporate governance for the generation of organizational legitimacy. Taking a narrow view, corporate governance can be regarded as one mechanism legitimizing a corporation through the appointment of a corporate board (Hillman and Dalziel 2003). Taking a broader view, corporate governance can be conceived of as a set of rules aimed at reducing business risks and thus as a guarantee mechanism (Gomez and Korine 2008). By means of proper corporate governance, a corporation signals to potential shareholders that it practices sound risk control. Thus, corporate governance enhances the trust of the shareholders in the corporation and minimizes potential transaction costs resulting from the collection of information about risks for investments. Building on this definition, we regard corporate governance as a mechanism that signals the ability of a corporation to control and limit risks for stakeholders, and thus contributes to organizational legitimacy.

The dominant shareholder-centered approach to corporate governance, which is adapted to the conditions of the preglobalization era, takes into account neither the individualization of risk nor the incongruence between shareholder value and social welfare. Therefore, this approach to corporate governance is no longer justified by the moral considerations outlined above and is becoming less effective in contributing to organizational legitimacy. Rather, due to its disregard of the negative effects of business activities (Tirole 2001), it potentially undermines corporate legitimacy. Therefore, the question is whether alternative approaches to corporate governance are available which have the potential to consider the risks borne by stakeholders of a business firm and thus to secure organizational legitimacy.

In Search of New Principles: Alternative Perspectives

Contesting conceptions of the purpose and objectives of a corporation and of the appropriate focus of corporate governance have been discussed for decades (Berle 1932; Clark 1916; Dodd 1932; Friedman 1970). With the aim of finding corporate governance mechanisms to cope with the challenges of risk society, in the following, we discuss the most influential alternative approaches to corporate governance (see also Gomez and Korine 2005, 2008; Scherer et al. 2012) with regard to their capacity to take into account the shift of risk toward stakeholders.

One attempt to modify corporate governance is *team production theory* (Blair 1995). As described above, the dominant approach to corporate governance has been conceptualized to overcome the principal–agent problem that is seen as threatening the efficiency of a corporation defined as a nexus of contracts. The core argument of team production theory is based on the increasing importance of implicit contracts and the resulting shift of risk toward stakeholders, particularly, the employees. They become risk bearers by (in part irrevocably) investing firm-specific skills in a team production effort—the firm—thereby contributing to value creation, without proper protection through explicit contracts. Consequently, team production theory aims at motivating team members to actually contribute to the process of value creation as well as increasing the amount of information available for decision making at the board level through participation of employees or knowledge workers (Osterloh and Frey 2006).

However, regarding the increasing importance of negative externalities, team production theory is constrained by the definition of organizations as teams and the resulting focus on team members. From this, it follows that external stakeholders such as individuals and groups affected by corporate action who do not make some kind of investment with which they voluntarily enter into a bilateral relationship with a firm cannot be regarded as team members. According to team production theory, risk imposed on these stakeholders by a corporation cannot be considered within corporate governance.

In line with the theory of team production, *stewardship theory* (Davis et al. 1997; Donaldson and Davis 1991) is based mainly on a critique of the dysfunctionalities of principal–agent theory, the framework that constitutes the shareholder primacy view. Instead of regarding managers as opportunists, stewardship theory assumes that the objectives of managers and shareholders correspond in general. Accordingly, stewardship theory postulates that governance structures that do not constrain the activities of managers motivate managers to maximize shareholder value. One advantage of stewardship theory lies in its emphasis on integrity of managerial decision making. However, stewardship theory seems to be unsuited to respond to the challenges that corporations are confronted with in the risk society. Being centered on shareholders as the central group of corporate governance, the reallocation of risk from the risk producers and the societal level to individuals will only be taken into account if this issue is taken into consideration by corporate managers. However, a conflict between the interests of corporate shareholders and stakeholders occurs (Friedman 1970) as soon as the consideration of risks for stakeholders conflicts with the financial interests of the shareholders.

The concept of *stakeholder democracy* (Matten and Crane 2005b), which can be regarded as an extension of stakeholder theories (Freeman 1984; Freeman et al. 2010), emphasizes the importance of democratic participation in corporate decision making. According to Gomez and Korine (2005, 2008), corporate governance can be regarded as a mechanism to secure the consent of the individuals governed by corporate actions, e.g., all stakeholders. The authors suggest that the democratization of corporate governance is a means to achieve the consent of the stakeholders of a firm. Therefore, stakeholder democracy has the potential to take into account the interests of all stakeholders affected by the reallocation of risks and to thus maintain or restore the legitimacy of business firms.

Summing up, dominant corporate governance theory, team production theory, and stewardship theory all have a limited focus on specific stakeholder groups and therefore lack the capacity to appropriately take into account the reallocation of risks. In contrast, suggestions to integrate stakeholders into organizational decision making directly aim at internalizing democratic processes within the boundaries of the corporation. Such openness to discourse and external control potentially allows to extend the focus of corporate governance beyond those stakeholders immediately involved in corporate value creation and makes possible to include all stakeholders affected by risk resulting from corporate action, be it risk resulting from insufficient enforcement of contracts, negative externalities, or corporate provision of public goods. By submitting them to democratic control, it becomes possible to insure that organizational decision processes take into account the changed allocation of risks and enable a concurrent resolution of conflicts between a corporation and its stakeholders.

From Contract to Social Connectedness: Readjusting the Scope of Corporate Governance

In principle, stakeholder democracy has the flexibility to take into account the reallocation of risks, which characterizes risk society by including stakeholders in corporate decision processes, and to thus compensate for the loss of corporate legitimacy. However, this flexibility makes it necessary to determine (1) which stakeholders are exposed to risk resulting from the activities of business firms and therefore need to be included in organizational decision making and (2) how the conflicting interests resulting from this reallocation of risk can be reconciled in order to constitute or maintain the legitimacy of corporate action. While the dominant approach to corporate governance theory as well as stewardship theory offers a simple criterion for selecting the stakeholders subject to protection by corporate governance—namely, the imperfect contractual relation between a corporation and its shareholders—this criterion is not applicable in the face of the individualization of risk, potentially including every individual. Hence, another selection criterion needs to be found.

One appropriate starting point seems to be the concept of implicit contracts, the criterion used by team production theory to determine how worthy of protection the stakeholders are. Implicit contracts are not formalized, but are nevertheless vital elements of economic transactions. Taking into account this type of contract in addition to explicit contracts facilitates the formulation of the relation between firms and an enlarged set of stakeholders in a systematic way, since risk not accounted for in explicit contracts becomes conspicuous (Boatright 2004, 2011). Nevertheless, despite its potential to address numerous legitimate claims on a corporation, the contractual view has its limits where relations between a corporation and its stakeholders are unidirectional, as in the case of negative externalities of the activities of business firms and the resulting risk for individuals. Redefining corporate responsibility by extending the notion of property rights to "both the legal aspect of property rights and the social conventions that govern (business) behaviors" (Asher et al. 2005) seems to be a promising way to recognize the importance of a firm's stakeholders (Blair 2005). However, the possibility of defining all stakeholder relations in terms of contracts and property rights, especially under conditions of complex global interdependencies characteristic for risk society, seems to be limited.

Consequently, the contract concept is not suitable for grasping the multiple relationships between corporations and their stakeholders. A further starting point is the concept of accountability. "An accountability relationship is one in which an individual, group or other entity makes demands on an agent to report on his or her activities, and has the ability to impose costs on the agent" (Keohane 2003, p. 139). According to Keohane (2003, p. 140), there are three normative criteria justifying and necessitating the accountability of an actor to specific groups: authorization, support, and impact. (1) *Authorization* defined as the conferring of rights from one entity to another is seen as one normative reason for the duty of the authorized to be accountable to the authorizer. (2) Political as well as financial *support* is regarded as another rationale for the obligation of the supported to be accountable vis-à-vis the supporters. (3) The third criterion—*impact*—is argued to further justify the agent's obligation to accountability. As argued by Held (2002), actors who become "choice-determining" for others and restrict the autonomy of these others need to be held accountable.

The issue of accountability in the shareholder-centered approach to corporate governance theory is exclusively centered on the criterion of support. Shareholders provide financial support for a corporation and in turn the corporation is supposed to be accountable to these shareholders. In the light of the growing economic and political power of corporations, the criterion of impact is becoming more and more relevant since corporations determine the choices of many people. However, due to the complexity of global exchange and power relations, the impact of specific actions on the constraint of individual choice is increasingly difficult to determine in a direct way. Impact in most instances does not happen directly, but through intricate cause–effect chains. Hence, to develop a concept of impact capable of embracing this complexity and intermediateness, we bring in the notion of *social connectedness*. According to Young (2004), to counter injustice—and therewith the constraint of individual choice—resulting from social and economic connectedness in a globalized economy, it is necessary to overcome a past-oriented liability logic. Instead, Young introduces the forward-looking concept of social connectedness. According to her, involvement in structures leading to injustice is regarded as a sufficient condition to consider an actor responsible since individual decisions are constrained due to the impact of this actor's actions. This becomes even more important because corporations impact individuals not only by economic exchange but also through externalities and the provision of public goods. Under such circumstances, impact cannot be determined following the logic of liability. Defining the impact of corporations according to the social connectedness perspective seems to be a fruitful approach with which to determine the scope of corporate accountability. Corporate governance, which plays a central role in securing corporate accountability, has to adapt to the changing economic and political operating conditions of corporations if it is to remain capable of fulfilling this objective. Instead of being centered on the protection of corporate shareholders, it needs to secure corporate accountability to all those affected by corporate action, even indirectly. The notion of social connectedness can be the basis for formulating the specifications of such an extended conceptualization of corporate governance, transcending the narrow focus on contractual relations and incorporating all risks produced by business and not covered by governmental regulation.

Tackling the Changed Allocation of Risk: The Role of Corporate Governance

We have described the inappropriateness of shareholder-centered approaches to corporate governance in the light of the individualization of risk and the weak link between the maximization of shareholder value and social welfare, and the resulting legitimacy problems of business. Further, we demonstrated the potential suitability of stakeholder democracy to generate corporate legitimacy by including the interests of all parties affected by a firm's activities into corporate decision making. While the stakeholder approach argues that such an inclusion is conducive to the maximization of corporate value, we argue that this argument is not strong enough to encourage corporate decision makers to consider all stakeholders that are exposed to the risks resulting from corporate activities. In the following, we firstly show why corporate governance is crucial for guaranteeing a fair allocation of such risks. Secondly, we explain how corporate governance can be modified to achieve this objective. In addition, we analyze the compatibility of a democratization of corporate governance with law and illustrate ways to implement democratic principles on the level of corporate governance by reference to the example of stakeholder panels that are becoming popular among many multinational corporations.

Corporate Governance as a Guarantee for a Fair Allocation of Risks

As shown by Gomez and Korine (2008), an identifiable mechanism is necessary to signal trustworthiness and establish confidence in the governance of corporations so that investors are willing to invest in a corporation and other stakeholders consent to the activities of a corporation. In light of the shifting allocation of risks, corporate governance structures that trustworthily signal the capacity of a business firm to limit the risks for stakeholders are crucial for securing organizational legitimacy for several reasons. First, the upper echelons in corporations wield the most power—in economic terms and increasingly also politically. At the top management level, fundamental directions in the course of strategic decision making are selected (Hambrick and Mason 1984; Schreyögg and Steinmann 1987), which shape the relation between corporations and society (Kemp 2011) and therefore influence the allocation of risks. Examples are decisions to make a foreign direct investment in a country with a poor human rights record or to engage in a highly disputed industry such as genetic engineering. Second, responsibility for the allocation of risks needs to be easily localized and identified by shareholders as well as by the general public. While the general capacity of a firm to limit the risks for stakeholders is difficult to assess for external observers, the design of corporate governance can serve as a clear signal that business firms take into account their effects on shareholders as well as on other stakeholders. Third, there is a possibility of failure of processes aimed at a fair allocation of risks at the lower levels of a firm. Distortions in moral deliberation resulting from the hierarchical structure of firms and causing a diffusion of personal responsibility (Rhee 2008) cannot be ruled out. Hence, some kind of guarantee equivalent to a court of last resort is necessary to provide the possibility of changing the direction of corporate activity and to insure that the risks resulting from the activities of business firms are allocated in a way that is perceived as legitimate by all stakeholders.

Mitigating Risks and Maintaining Legitimacy: The Role of Deliberation in Corporate Governance

In the following, we suggest that the opening up of corporate governance structures and corporate control processes to communicative processes with civil society is a suitable way to address the risks resulting from the activities of business firms in a procedural communication-based way and to simultaneously safeguard corporate legitimacy. As a response to the limited capacity of nation states to address the problems associated with the emergence of risk society, Beck (1992, 1997) proposed the concept of *subpolitics* as a way to tackle risk that lies beyond the reach of regulatory authorities. In subpolitics, civil society actors such as communities and NGOs engage in political processes with the aim to compensate for the decreasing regulatory capacity of the nation state. Suggestions to concretize mechanisms for assessing and governing risks within the scope of subpolitics (see, e.g., Bäckstrand 2004) build on the theory of deliberative democracy (Habermas 1998; Dryzek 1999). In this theory, deliberation is conceived as a network of argumentation aimed at controlling administrative power by finding rational and fair solutions for problems of public interest (Habermas 1996). In the course of deliberative processes, civil society actors can collectively assess and govern risks in a legitimate manner (see, e.g., Pellizzoni 2001, for the case of the assessment of the risks of gene technology). With the increasing power of business, firms become increasingly exposed to subpolitical protests (Scherer and Palazzo 2007). While on the one hand such subpolitical activities are potentially harmful for business firms, on the other hand they open up a new arena for interaction between civil society and business firms, where risks of business activities can be collectively assessed and governed in a communicative way.

Indeed, Palazzo and Scherer (2006) suggested that such an engagement of business firms with civil society might be a way to manage the legitimacy of organizations in a procedural communication-based way. Referring to the threefold concept of legitimacy put forward by Suchman (1995) and described above—pragmatic, cognitive, and moral legitimacy—these authors argue that under the conditions of globalization, the capability of business to constitute pragmatic or cognitive legitimacy is decreasing. Transferring the theory of deliberative democracy from political science to the context of business organizations (Palazzo and Scherer 2006; Scherer and Palazzo 2007), deliberation is regarded as a means for corporations to compensate for the loss of pragmatic and cognitive legitimacy. Switching to a mode of "moral reasoning" is regarded as a measure to constitute moral legitimacy by means of discursive processes when necessary and appropriate. The process of deliberation is seen as a way to achieve legitimate outcomes by an active justification vis-à-vis society through the exchange of good reasons (Palazzo and Scherer 2006). These considerations illustrate that the design of corporate governance according to the principles of deliberative democracy has the potential to tackle the risks that result from activities of business firms and to thus safeguard their legitimacy.

Company Law, Soft Law, and Democratic Corporate Governance

Obviously, even if the democratization of corporate governance is an appropriate response to the changing allocation of risks discussed above, the question remains to what extent such a radical redesign of governance structures and profound reallocation of rights is compatible with company law. Contrary to the common assumption that company law requires the maximization of shareholder value, the maximization of shareholder value is not a legal principle (Stout 2008, see also Elhauge 2005; Rose 2007). Rather, corporate law suggests that the purpose of the firm is to "serve the interests of employees, creditors, customers, and the broader society" (Williams and Conley 2005, p. 1190) and requires corporate directors to promote the long-term success of a business firm for the benefit of its various stakeholders (Lan and Heracleous 2010). As we have demonstrated, the democratization of corporate governance is an appropriate means for safeguarding the legitimacy and thus the viability of a business firm in cases where business firms operate under conditions of weak regulatory frameworks. In cases where there is no other means available for guaranteeing the viability of a business firm, an opening up of corporate governance for democratic processes therefore seems to be a lawful means to insure that a firm can continue to serve the interests of its stakeholders as well as a means to signal this capacity to prospective shareholders (Gomez and Korine 2008). In addition to the positive influence of stakeholder participation on corporate legitimacy, there is increasing evidence that close interaction with stakeholders on the level of corporate governance is conducive to the management of business risks (Pirson and Turnbull 2011) as well as to innovation (Spitzeck and Hansen 2010). These considerations make clear that the representation of stakeholders in corporate governance is not only compatible with legal prescriptions but might also be helpful for maintaining or restoring corporate legitimacy, thus guaranteeing the long-term success of a corporation under conditions of ineffective or absent regulatory frameworks. Seen from this perspective, a democratization of corporate governance might be in the economic interest of a firm and therefore in the immediate interest of a firm's shareholders. The idea of a corporate governance model that is by default attractive for stakeholder groups with allegedly diverging interests partly corresponds with the ideas of Black and Kraakman (1996), who propose a "self-enforcing model of corporate law" for countries where the official enforcement of contracts is weak. These authors argue that an appropriately designed set of default rules for corporate governance might even work under conditions of weak enforcement due to the pressure of peers, threats to the reputation of a corporation, and the danger of violent protests against decisions of corporations. The same arguments hold as a rationale for a voluntary democratization of corporate governance as a means to tackle the shifting allocation of risks and the concomitant legitimacy problems of business. As argued by Turnbull (2000), the concept of a self-enforcing model of corporate law might serve as the basis for the policies of governments and development agencies to promote democratic forms of corporate governance. Building on this idea, in the following, we discuss the feasibility and prospect of a legal and soft legal enforcement of democratic corporate governance.

As demonstrated by the case of Germany, the inclusion of stakeholders in corporate governance can also be required by law. German law requires the inclusion of workers' representatives in corporate boards in firms of a certain size (see, e.g., Jürgens et al. 2000). This example illustrates that law can play an important role in enforcing the inclusion of different stakeholders in corporate governance.

Beyond strictly legal approaches to the democratization of corporate governance, it is also possible to conceive of soft law approaches to the promotion of democratic corporate governance. For instance, the demand of the OECD Principles of Corporate Governance that the board of a corporation "should take into account the interests of stakeholders" (OECD 2004, p. 24) could conceivably be complemented by a clause that requires the formal inclusion of stakeholders in corporate governance. Further, more indirect effects of soft law on corporate governance are conceivable. For instance, as argued by Muchlinski, the provisions of the UN framework on human rights and business concerning the development of human rights compliance systems have the potential to transform the shareholder-centered model of corporate governance toward a model of the corporation that builds "upon the implications of stakeholder theory for the reform of corporate law and regulation" (Muchlinski 2012, p. 167).

At first glance, it might appear somewhat paradoxical to conceive required democratization of corporate governance by law or soft law as one means to address problems in areas in which laws are weak. However, at second glance, the described law and soft law approaches might serve as blueprints for indirect legal remedies of governance gaps. While law is incapable of directly addressing governance gaps per definition, it is conceivable to require business firms to open up their decision structures in their home countries as a means to address problematic issues in host countries. For instance, the inclusion of the representative of a civil society organization that promotes the protection of human rights in the board of a European business firm might be an appropriate means to avoid the complicity of this firm in the violation of human rights in areas where there is no proper rule of law.

Even if these considerations pose several essential questions concerning the selection of stakeholders and the redesign of governance structures, we hold that a democratization of corporate governance required by law or soft law might be a way to indirectly tackle governance gaps. Concerning the concrete form of such a democratization, the emerging practice of stakeholder panels described in the following section has the potential to offer insights.

Concretizing Democratic Corporate Governance: The Case Of Stakeholder Panels

Suggestions to modify corporate governance structures reach from the inclusion of outside directors into corporate boards to the comprehensive redesign of corporate governance structures. Ideas to achieve the latter goal comprise suggestions to increase the complexity of corporate governance structures by raising the number of corporate boards (Pirson and Turnbull 2011; Turnbull 1994) and to create novel instances such as "stakeholder liaison groups" (Tricker 2011) on the one hand and proposals to connect political decision making with societal discourses within a "chamber of discourses" (Dryzek and Niemeyer 2008) on the other hand.

In practice, it can be observed that more and more business firms interact with stakeholders on a regular basis, often within the scope of stakeholder panels (AccountAbility and Utopies 2007). In the literature (Scherer et al. 2013; Spitzeck et al. 2011) such stakeholder panels are described as modifications of the corporate governance structures of corporations. In what follows, we show that the emergence of stakeholder panels can be explained with reference to our considerations on the shifting allocation of risks generated by business firms and the role of deliberative democracy in the level of corporate governance for moderating these risks. Basically, the inclusion of stakeholders in corporate governance can either comprise information rights or participation in decision making (Williamson 1985). Concerning the case of information rights, there is a range of business firms that engage stakeholder panels in the process of reporting information on social and ecological issues. For instance, the External Report Review Panel of cement producer Holcim has the task to "challenge the company's approach to sustainable development… as well as to form an opinion on the company's sustainable development performance and reporting" (Holcim 2012, p. 1). The statements of the panel are publicized on the company's website. Similarly, Kingfisher, a large home improvement retailer, publicizes the feedback of its External Stakeholder Panel as well as the company's response to this feedback (Kingfisher 2012). Such processes of review, assurance, and exchange of arguments conform with the principles of deliberative democracy insofar as they can be regarded as a form of public discussion, since the comments of stakeholder panels on sustainability reports of business firms are in many cases published in a (purportedly) uncensored manner, allowing the readers to form their opinion in an unbiased way.

The direct participation of stakeholders in decision making of business firms is currently less developed. While there are a number of stakeholder panels that are designated to inform the formulation of corporate strategies, their actual power to influence corporate decisions seems to be low (see also Spitzeck and Hansen 2010). However, we regard the emergence of forums for the exchange of information between top-level managers and stakeholders as a noticeable improvement of governance structures. Such forums firstly increase the informational basis for organizational decision making. Secondly, they constitute an arena for the mutual exchange of information that is potentially conducive to mutual understanding and a change of practices in accordance with this. Interestingly, stakeholder panels resemble the "stakeholder advisory boards" conceived by Evan and Freeman (1988) as a transitional step toward a stakeholder-controlled corporation.

The reasons for setting up stakeholder panels are manifold. On the one hand, the input of stakeholder panels can be primarily regarded as an instrumental means aimed at detecting factors that affect the success of a company, as exemplified by the Sustainability External Advisory Council of Dow Chemical that addresses corporate success factors, business/portfolio success factors, public affairs and stakeholder engagement, and trends and externalities (Dow Chemical 2012). However, in some cases, the purpose of stakeholder panels transcends immediate economic considerations. There is evidence that the shifting allocation of risks described above seems to be increasingly recognized on the part of business. For instance, one of the stated purposes of the Sustainable Development Panel of energy producer EDF is to assess how well the interests of stakeholders are taken into account (EDF 2012). Similarly, monitoring the efforts of business firms to protect human rights is the focus of many stakeholder panels (see, e.g., Areva 2007; BP 2013). This can be taken as evidence that business firms increasingly realize that stakeholders might be in need of additional protection beyond legal protection. Next, a topic that permeates many reports and mission statements of stakeholder panels (see, e.g., Dow Chemical 2012; Holcim 2012; Shell 2012) is the issue of climate change, which is the most striking example for negative externalities generated by business firms. Finally, the provision of public goods such as healthcare, education, and public transport by business firms is increasingly moving into the scope of stakeholder panels, as the example of BP's Tangguh Independent Advisory Panel in Indonesia illustrates (BP 2013).

The described involvement of stakeholders in corporate governance illustrates that business firms increasingly recognize the risks resulting from their activities for their stakeholders. The inclusion of stakeholders in organizational decision processes on a regular basis can be regarded as the attempt of business firms to address the shortcomings of a shareholder-centered approach to corporate governance by transcending the casual consultation of stakeholders, which are often characterized by unequal power relations (Banerjee 2008). Through the inclusion of stakeholders, corporate governance becomes a subpolitical arena, which can (at least provisionally and partly) compensate for lacking governmental and regulatory protection of stakeholders from risks and contribute to the legitimacy of business firms.

Concluding Remarks and Directions for Further Research

In the pre-globalization era, non-shareholding stakeholders of business firms were in many cases sufficiently protected by law and regulation, negative externalities were (at least partly) avoided or compensated by law and proper state governance, and the provision of public goods was a public task fulfilled by public authorities. With the diminution of public steering power and the widening of regulation gaps, these assumptions are becoming partly untenable. In many cases, stakeholders of business firms lack protection by nation state legislation. The limitation of negative externalities by state authorities is becoming increasingly difficult due to the global reach of corporate power, the range of many negative externalities transcending national borders, and the weakening of national regulatory frameworks. The distinction between the private and the public sphere is blurring because corporations often participate or independently engage in the provision of public goods. As a result, many stakeholders of business firms are increasingly individually exposed to risk that results from corporate activities, and the assumed link between the maximization of shareholder value and social welfare is weakening—with adverse effects on the legitimacy and viability of business firms.

Corporate governance has the potential to address these issues. To successfully moderate among the interests of individuals, corporations, and society and thereby maintain or restore organizational legitimacy, corporate governance needs to be open to contingent legitimate claims on a corporation with the aim of controlling and mitigating risks resulting from corporate action. The suggested approach builds on stakeholder theory. However, we extend it insofar as we not only claim the need to consider corporate stakeholders in corporate decisions but also demand the inclusion of all corporate stakeholders that are negatively affected by corporate activities into organizational decision processes. The transfer of the concept of deliberative democracy to the corporate level in general and to corporate governance in particular promises to tackle the risks which result from the activities of business in a globalized economy and to realign the objectives of business firms and society in a discursive way. Thus, the moral deficiencies of shareholder-centered corporate governance can be addressed and the legitimacy of a business firm can be reestablished.

Our findings contribute to extant research on the democratization of corporate governance (see, e.g., Driver and Thompson 2002; Gomez and Korine 2005, 2008; Parker 2002; Scherer et al. 2013; Spitzeck et al. 2011) in several regards. First, we show that shareholder-centered approaches to corporate governance that are justified by the residual risk borne by shareholders or by the maximization of social welfare allegedly accruing from the maximization of shareholder value are not appropriate in light of globalization and the individualization of risk in risk society. For this reason, these approaches are a potential threat to the legitimacy of business firms. We detail that democratic processes on the level of corporate governance can help avoid undue risks for stakeholders, insure the contribution of business to the social good, and therefore help maintain or restore the legitimacy of business. Next, we show that reliance on contracts as a criterion for determining the inclusion of stakeholders in corporate governance is increasingly inappropriate in view of the complexity of global exchange relations and the unilateral exercise of power through business firms. Instead, we suggest that the concept of social connectedness can serve as a criterion for the selection of stakeholders to be represented in corporate governance. Finally, we show that a legally or soft legally mandated democratization of corporate governance of business firms in home countries of a firm where law is assumed to be relatively strong might be an approach appropriate for indirectly tackling governance gaps in areas where law and regulation are weak.

Further research is firstly necessary to find ways to process and balance legitimate claims toward an organization and organizational efficiency. One promising step in this direction is the further analysis of the compatibility of cybernetics-based approaches to organizational design (e.g., Pirson and Turnbull 2011; Romme and Endenburg 2006) and the principles of deliberative democracy (e.g., Dryzek 1999; Habermas 1996, 1998). Secondly, on the level of global governance, effective schemes of regulation need to be found to foster corporate commitment for goals that transcend the generation of shareholder value and to facilitate the adoption of more versatile forms of corporate governance.

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